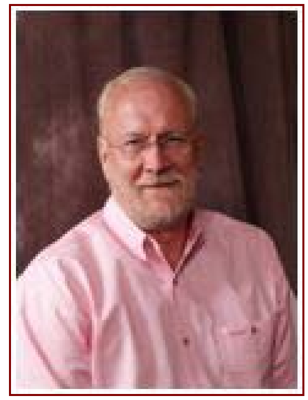
Whiteside & Associates

TRANSPORTATION Update



From: Terry Whiteside

To: Montana Wheat & Barley Committee

Date: January 13, 2012

Revised

CP Leadership Is In Flux - Proxy Fight Looming

CP is the southernmost railroad in Canada running the entire length of the prairie provinces. It serves export terminals in Vancouver, Minneapolis, Thunder Bay and Montreal.

An activist hedge fund investor said he will wage a proxy battle to replace the top leadership of Canadian Pacific Railway after the railroad's directors rejected his attempt to tap a former Canadian National Railway CEO as chief, according to published reports.

William Ackman, principal of Pershing Square Management, wants to replace Fred Green with Hunter Harrison, who helped Canadian National become one of the most profitable railroads in North America.

CP directors unanimously rejected Ackman's attempt and said Green has the board's "full support" in executing the railroad's plan "to achieve a low 70s operating ratio in the next three years."

"We have a legendary CEO with an incredible track record," Ackman told the New York Times. "Who better to bring an underperforming competitor up to snuff?"

Ackman, whose firm is the railroad's largest shareholder, said he expects Harrison's past performance to allow his fund to replace the 15-member board at the next annual meeting. Last year's Board Meeting took place in May.

National Truckers - Are Up In Arms - About Newly Proposed Regulations - Limiting Their Running Time and Mandating Down Time - Washington D.C. Rally - February 1st

Truckers and Shippers Are Angry At Newly Proposed Work Rules That Will Raise Costs of Trucking Everywhere

The FMCSA's (Federal Carrier Safety Administration) proposed rule would also require all work to be completed within a 13-hour on-duty period and revise the weekly 34-hour restart to require drivers be off-duty for two consecutive 12 a.m.-6 a.m. periods before starting a new week.

If the final rule includes those changes, the impact on trucking and shipping costs would be dramatic, according to the American Trucking Association. The ATA estimates the HOS changes would cost trucking billions of dollars without delivering safety benefits.
A dozen shipper and trucking organizations are planning a one-day blitz on Capitol Hill Feb. 1 to voice opposition to regulations they say will burden the trucking industry and raise shipping costs as much as 10 percent. This is predicted to be the largest Trucking One-Day Blitz in history.

Rural states will get hard hit by this action - as most of their inter-city freight is transported by interstate trucking operators. Also remember that truck rates, in areas where there no river competition, may serve as a floor for rail rate levels.

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Rail Intermodal Volume Up 22.9 Percent Year over Year - A Sign of Recovery?

One of the indicators that economists look for to forecast a recovery is transportation. Transportation is both a lagging indicator going into an economic downturn and a leading indicator coming out of downturn.   Is this true in 2012, where the railroads with their market power have been able to grow virtually throughout the recession? The volumes of truck and rail feel off over the last 36 months but in the case of rails - their revenues have sustained. We are starting to see increasing positive trends in transport statistics in rail and truck.

JOC Staff | Jan 1, 2012 1:05AM GMT
Excerpts from The Journal of Commerce Online - News Story

"Intermodal volume for major U.S. railroads soared 22.9 percent year-over-year in the week ending Dec. 24, a likely signal that businesses were moving to replenish their lean inventories heading into the New Year.

Carload traffic for the Class I railroads grew 11.9 percent year-over-year in the week ending Christmas Eve, the second straight double-digit increase.

These are positive signs looking towards a strengthening recovery.

However, the forecast cannot be said to all rosy. While not many economists are forecasting another recession in 2012 - the same is not true for Europe. Most economists believe that Europe will slip into a recession in 2012 and that will perhaps delay recovery in the U.S in 2012.

While this can play out many different ways, if these forecasts are true look prospects for carriers on the trans-Pacific to be better than in the Asia-Europe market, "given supply adjustments" and the "not so bad" demand outlook from the United States."

Look for Longer and Longer Trains In Future Railroading

130+ car Trains in the future - the future is now. Major railroads, dwelling on economies of scale, plan to invest billions in sidings and locomotives. Will the shippers see any of the savings or economies of scale - or just the downside to longer dwell times and lengthening delivery times?

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Mark Szakonyi | Dec 22, 2011 5:28PM GMT
Excerpts from The Journal of Commerce Magazine - News Story

“Rail efficiency has reached it limits with current technology and without enormous expenditures by railroads/government into dual tracking wrestling increasing efficiency may prove to be elusive. Intermodal efficiency is at a maximum with stacking containers vertically, thus railroads are increasingly looking for improvements in the other directions. North American rail carriers are running longer trains to gain the sort of economies of scale ocean carriers are getting from their new giant container ships. It is not unusual to see 130+ car trains running on the western railroads compared to the traditional 100-110 car.

Railroads View: Longer trains reduce fuel consumption and reduce capital maintenance and labor costs, while improving safety and efficiency, railroad executives say.

Rail Shippers View: Rail shippers are less likely to benefit from the adoption of super-sized equipment than they are on the water. Longer trains can translate into longer dwell times for shipments. Containers can be held from shipment until there are enough boxes to put together a longer train.

Railroad executives counter this argument say a slightly longer dwell time won’t throw off the delivery of a container. Still, even if deadlines are met, many containers will arrive later than they would have if the railroad ran shorter trains. The railroads contend that longer trains can benefit shippers whose loads arrive later.

“Longer trains allow us to respond to volume variability without adding extra train starts or leaving business behind, thus improving service for our customers,” said Mike Francszak, executive vice president of operations at Canadian Pacific Railway.

CP is in the midst of a drive to improve its operating efficiency by extending trains, especially those serving the relatively low-yield bulk commodities such as potash that are the railroad’s core business. It’s part of an effort to make the business more financially efficient. But in general, rail industry observers say, rail shippers are also unlikely to get a break in rates through the use of larger equipment. Although the use of larger vessels has fostered enormous rate competition on the water, railroads are under little pressure to cut rates because of the lack of competition they face from other railroads and other transportation modes, such as trucks or barges.

The Class I rail industry’s pricing power has been reflected in railroads’ quarterly earnings in recent years, with the latest round of earnings reports as the strongest testament. Many major railroads in the third quarter saw their profit margins rise by double digits on single-digit freight gains.

Some rail customers, especially coal shippers, could see a break in rates if contracts call for shared savings but most do not have such clauses."

Remember that rail customers are called upon to bear any increased costs that are borne by the railroads, such as the adverse effects of coal dust on the roadbeds. Trains carrying coal and agriculture shipments often are limited in length by the size of the loading capabilities of utilities and grain terminals. Most grain terminals on BNSF in the western U.S. are sized for 110 maximums and are of a loop configuration - that cannot be easily retrofitted to accommodate larger train sets.

Pipeline by Rail' Planned in Colorado - Unit Trains Of Oil To Export Terminals - UP and BNSF

Joseph Bonney, Senior Editor | Jan 11, 2012 9:14PM GMT
The Journal of Commerce Online - News Story

"Musket Corp. plans to open a crude-oil export terminal at Windsor, Colo., for unit train shipments using a newly constructed four-mile loop on the Great Western Railway, which interchanges with BNSF and Union Pacific.

The 320-acre site at the Great Western Industrial Park has fuel storage tanks with 48,000 barrels of capacity, which will be converted to crude oil service. Site will have initial loading capacity of 5.8 million barrels a year and is designed for expansion.

"With increasing oil production in the Denver-Julesburg Basin and exploration of the Niobara Formation, northern Colorado needs a rail-based solution to efficiently transport crude-oil unit trains," said Rich Montgomery, vice president of The Broe Group, a Denver-based manager of real estate.

Denver-based Broe manages 29 million square feet of real estate in North America, including more than 750,000 square feet of industrial facilities in northern Colorado.

Houston-based Musket previously invested in a "pipeline-by-rail" terminal in North Dakota's Bakken shale region. "We are excited to extend this strategy to the DJ Basin," said J.P. Fjeld-Hansen, managing director of Musket Corp.

Broe's transportation affiliate, OmiTRAX Inc., has rail, port and terminal operations including Great Western Railway, which will extend its track to complete a four-mile-long loop to serve the Musket terminal and others in the industrial park.

The northern central plains are becoming filled up with tank-cars located in virtually every rail yard in North Dakota and Montana. Look for this trend to continue as the new production continues to outstrip the ability to move the oil to refining centers in OK and TX."

STB Opens Ex Parte No. 712 - Improving Regulation and Regulatory Review

The STB at the urging of Senator Rockefeller to Chairman Elliott last fall - and support of the Chairman and the two Board members has opened a proceeding designed to look at current regulatory oversight and a review of regulation.

The Alliance for Rail Competition together with Colorado Wheat Administrative Committee, Montana Wheat & Barley Committee, Idaho Wheat Commission, Idaho Barley Commission, Texas Wheat Producers Association, Oklahoma Wheat Commission, South Dakota Wheat Commission and Washington Grain Commission filed Opening Comments early this week.

"The STB engages primarily in economic regulation, and is charged by Congress with balancing the need of the railroad industry for adequate revenues with the need of captive shippers for protection against abuses of railroad power, as well as the need of all shippers for reasonable railroad practices, including car supplies, interchanges, and common carrier service. The railroad industry, like trucking, ocean shipping, and air transport, is important not in itself but because its services support the larger U.S. and global economies."

" ARC, et al, fully expects railroads to claim in this proceeding that they are overregulated, but it is difficult to identify any legitimate interests that major railroads have been prevented from pursuing due to STB prohibitions. Given the immunity from antitrust claims by captive customers that railroads enjoy under the Keogh doctrine, and federal preemption of state regulation under 49 U.S.C. §10501, railroads are the least regulated industry in the U.S., among industries enjoying significant market power."

"That market power is also unparalleled in many states, regions and market segments, such as grain, coal and other bulk commodities for which service by Class I railroads is required. The fact that more than 90% of rail freight is controlled by just four railroads, two in the East and two in the West, is indicative of extreme market power. The major Class Is have largely neutralized potential competition from Class II and Class III railroads through paper and steel barriers and through the commercial leverage they have over whether a short line will survive. Competition among Class Is limited due to factors such as the Bottleneck decisions and the Mid-Tec case."

"The Board needs to recognize, as Warren Buffett, Wall Street, and the Class Is themselves do, that revenue inadequacy is no longer a problem for major railroads, which have learned to price their services for captive and competitive customers in such a way as to have no difficulty attracting investment and capital."

1. Simplify Rate Cases and Eliminate Rate Relief Caps: " The Board should revisit and eliminate its relief caps for simplified rate cases.
2. Small Rate Case Procedure - Three Benchmark test: "The Three Benchmark test is a weak limit on rail rates in the best of circumstances, inasmuch as it produces maximum lawful rates that may exceed the threshold of STB jurisdiction by 100 percentage points or more.[1] The Board could and should improve the effectiveness of this form of rate regulation by adopting measures that address railroad gaming that prevents the possibility of a meaningful comparison group."
3. Ancillary and accessorial Charges challenge procedures: "...ancillary or accessorial charges (tend) to be an unregulated profit center for railroads, subject to relief only if a captive shipper challenges the charge in the course of litigating a broader rate case? If so, will the Board order excessive charges reduced to levels approximating costs? Today, STB regulation of rail charges is not effective."
4. Establishing Competition - Standards: "Given the importance of market dominance determinations in rate cases, the Board should clarify that regulatory recourse will be denied based on the presence of competition only when that competition has been shown to be effective."

[1] See US Magnesium, LLC v. Union Pacific, Docket STB No. 42114, decision served January 28, 2010, in which prescribed rates, despite significant reductions, remained above 300% of variable cost.

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